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C O N F I D E N T I A L SECTION 01 OF 07 MOSCOW 002393

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SUBJECT: THE 2ND ASIAN ENERGY OFFICERS CONFERENCE --  
RUSSIAN SUPPLY MEETS ASIAN DEMAND

Classified By: Econ M/C Pamela G. Quanrud. Reasons 1.4 (b/d).

11. (C) Summary. On April 19-20, Embassy Moscow hosted energy officers from regional Embassies and Washington DC-based USG officials at the 2nd Asia Energy Officers Conference. The conference focused on the still nascent oil and gas linkages between energy-rich Russia and energy-hungry Asia. Russian and foreign energy companies and leading think-tankers briefed attendees on the complex issue of putting together Russian supply and Asian demand. The key themes were a growing Chinese-Russian rivalry for energy dominance in Central Asia; the rising importance of gas decision-making (relative to oil); Russian foot-dragging holding back consummation of regional ties; uncertainty over some resources and infrastructure (particularly pipeline routes); and the ubiquitous and lumbering Russian energy giant Gazprom as the linchpin to solving (or blocking) key projects. End Summary.

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TNK-BP

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12. (C) Alistair Ferguson and Shawn McCormick provided an overview of Russia's looming gas imbalance and a harsh assessment of Gazprom's ability to deal with what could become a crisis. Gazprom's modus operandi is to "lie, cheat, and steal" about gas numbers and Gazprom "manages demand out" of the equation rather than finding new supply. TNK-BP estimates that Russia operated at a 4-5 bcm/y deficit in 2006, and that will grow to about 10-12 bcm this coming winter. Russia will do all it can to meet export commitments, and there is a definite recognition of interdependence with Europe.

13. (C) One significant thing that has changed since the last Asian Energy Officers conference in December 2005 is that it is apparent now that Russia is unable to follow through on strategic decisions. Promising 30-40 billion cubic meters of natural gas to China by 2020, for example, means that geotechnical work must be underway now, yet Gazprom stands in the way of projects in the east. To move West Siberian gas to China through the so-called Altai route would drain gas from Europe, as production has reached a plateau and is insufficient to supply both markets. Since it is unlikely that Gazprom will walk away from its base European markets, the company will look elsewhere for new reserves. Developing

the big fields on Yamal, in TNK-BP's estimation, is much more difficult and expensive than estimated, and at the earliest a 2015-2020 proposition.

14. (C) As a result, Central Asian gas, as well as gas produced by independents (non-Gazprom companies), is absolutely critical to Russia's gas balance. At the same time, China's growing inroads to its west present the Central Asian countries with a chance to play the two superpowers off each other. The gas balance problem is "not a crisis yet," but Gazprom's growing needs present companies like TNK-BP with opportunities and TNK-BP will not "wait until it is a crisis." In fact, TNK-BP is sufficiently confident in the ultimate outcome -) that it will be able to produce and market additional gas -- that it is budgeting \$300 million on Kovykta development annually despite having no resolution to its impasse with Gazprom over development of the field.

15. (C) TNK-BP, angry over the indecision over development of Kovykta, vowed to attack Gazprom head-on since Gazprom simply "cannot control it all." With gas sector reform slowly strengthening in Russia, gas prices gradually rising, an electricity crisis looming, and the hastily-passed export monopoly law even coming under increasing fire, 2007-8 marks a moment of opportunity to break through the Gazprom barrier. Gazprom is at the "zenith of its power" at the moment, but Gazprom really has no strategy other than increasing its market capitalization while its motivations are almost entirely driven by politics and vested interests rather than business fundamentals. This is temporarily Gazprom's strength but also its longer-term weakness. As long as Gazprom is happy only with "domination and bulldozing," domestic supply problems will grow and will threaten exports,

MOSCOW 00002393 002 OF 007

and powerful authorities will increasingly recognize that Gazprom is retarding rather than promoting growth in places like East Siberia. At that point, the vested interests in Gazprom could be upended while business fundamentals come to trump politics. If not, Gazprom will simply grow weaker, or at least more dysfunctional.

ExxonMobil  
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16. (C) Erik Houlleberghs, Peter Lundh, and Ed Verona provided an overview of energy demand in the Russian Far East and Asian markets and a brief summary of the Sakhalin 1 project, but most of their presentation was a thesis on how to move forward with Gazprom in Russia's east. There is no doubt about Asian demand, and projects such as Sakhalin-1 are proving that Russian supply is sufficient to meet it. ExxonMobil (EM) sees Russia's gasification strategy in the east quite differently than does TNK-BP, however. The Russian government has undertaken a series of complementary policies and legislative initiatives to develop the gas arena in the east. These include the federal gas export monopoly law (passed); a program (under final approval) establishing an integrated production, transportation and supply system in the east; a program (draft) on natural gas production; and a separate program (draft) on a gas transportation system, including for export. This would all go towards establishing a Unified Gas Supply System (UGSS) in the east that roughly replicates what Russia has in the west.

17. (C) The problem with Russia's plan is that it is impossible to carry out. From 2009 to 2017 the plan calls for bringing on-stream no less than eleven huge new sources of gas to meet its commitments. These fields are spread across virgin territory the size of the continental U.S., and the projects will require enormous investments on a shocking scale. EM by contrast sees few of these projects coming on-stream until at least 2015 or 2020, with the exception of the Kovykta gas project and obviously Sakhalin-1 and -2. Sakhalin-1, in which ExxonMobil and Rosneft are partners, has made good progress. Unlike most of the agreements Russia and

China have signed on energy, the Heads of Agreement that Sakhalin-1 signed with China, s CNPC includes a detailed price formula. China has finally realized it must pay world prices for gas, at least from Sakhalin-1, and is moving away from its obsession with using coal as a basis for setting import prices in favor of LNG as the price-setter. Since gas is essentially a peak-shaving fuel for China, it can afford to pay relatively high prices for it. Sakhalin-1's proposed gas pipeline to China can serve as the basis for Russia's eastern UGSS. To ExxonMobil, s chagrin, however, Sakhalin-1 export rights are still uncertain.

18. (C) All this leaves Russia with a giant need for foreign partnerships in the east, but this will be difficult given the inherent conflicts of interest Gazprom brings to the table. Nevertheless, on the oil and gas fronts at least, international companies will be able to establish such partnerships with Gazprom and other Russian majors. For example, despite some internal vested interests that would ordinarily compel Gazprom to want to divert Sakhalin-1 gas into Sakhalin-2's LNG facility, Gazprom might be satisfied with its Sakhalin-2 role and honor Sakhalin-1's PSA rights to export the LNG as it sees fit. It helps that EM's calculations show fairly definitively that piping Sakhalin-1's gas to China is more profitable to all stakeholders than sending it anywhere as LNG. On the other hand, Gazprom is loath to allow other companies to export gas.

19. (C) In a separate conversation with Beijing Econoff, Verona stated that it is critical for China to finalize an agreement for Sakhalin-1 gas as soon as possible. By doing so, it may be able to preempt Gazprom's involvement in the project. Verona said that China's unwillingness to cross Gazprom is clearly influencing its measured steps to date in negotiating for the gas.

110. (C) The survivors of Russia's 2008 political transition will have an impact on whether such partnerships succeed.

MOSCOW 00002393 003 OF 007

Whatever happens, Russia's remaining dependency on Europe will continue to reduce Russia's freedom to act, while Central Asia will turn its attention to the east even more, fostering opportunities for cooperation and competition with Russia. Kazakhstan, for example, may find it easier to ship gas east than west in the face of Russian opposition to trans-Caspian routes. Kazakhstan has grand plans to develop a petrochemical industry and simply does not have enough gas to satisfy every direction on the compass, and China -- unlike Europe -- is just over the border. Given EM's view that a trans-Caspian gas pipeline is &unrealistic,8 EM wondered if USG rhetoric about it was meant to cause Russia anxiety and questioned why the West complains when Russia takes the same tack by talking of a gas OPEC.

Shell  
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111. (C) Alf D'Souza and Bibigul Baitluoeva characterized the Putin energy era as one of ensuring stability, safeguarding unity and control, restoring state capitalism, reacting to the perceived inequities of the Yeltsin era, and seizing the commanding heights of the economy. They labeled ConocoPhillips' strategic deal with Lukoil as a model of how much the international oil companies (IOCs) can get these days -- about 20-25 percent of equity and "not much control." As for Sakhalin Island, D'Souza compared the region to the North Sea at the early stages of its exploration and development. At that time the North Sea was thought to contain around 4-5 billion barrels of recoverable oil, about the same as is already proved in the known Sakhalin fields.

112. (C) Shell's Sakhalin-2 project is now 80 percent complete and, thanks in part to project financing that the Japanese partners insisted upon, it represents a level of transparency not seen elsewhere in Russia. This despite some Russian

fears that the field's operators were giving themselves kickbacks. Shell confessed it had shot itself in the foot by not keeping all parties informed -) those conducting negotiations with Gazprom to swap shares of Sakhalin 2 for Shell's access to a West Siberian gas field and those preparing to announce Sakhalin-2 cost overruns at the same time. Nonetheless this made the Russians that signed the alliance look dumb, the authorities suspicious, and led to the campaign to replace the foreigners' majority control with Gazprom's. "When you are under attack in Russia, you are alone," D'Souza added.

¶13. (C) D'Souza went to great lengths to defend Sakhalin-2's performance, pointing out that most of the authorities' claims of regulatory violations by Sakhalin-2 were unfounded.

For example, it was unrelated pipelines from the Soviet era that were leaking and not Sakhalin-2's; dead fish that had upset Russian and some western television audiences were the result of natural spawning; and in the end the consortium had to pay only \$1 million in fines compared with the audacious estimates by some authorities of \$50 billion or more.

D'Souza also defended the recent deal with Gazprom (to sell the latter 51% of Sakhalin-2), which "was not expropriation."

Instead it is a fair deal that avoided arbitration. Shell will remain technical service provider for upstream and LNG and the western partners will retain a proportionate role in governance. He admitted the deal has taken a while to complete because it is highly legalistic but noted that such steps are essential since "forgiveness is not a Russian trait". All partners have now received their funds for the sale (totaling \$7.45 billion).

¶14. (C) D,Souza also pointed out Sakhalin 2 required 100,000 different licenses and permits and boasted that the project had consumed 18 million man hours without any deaths or accidents. He criticized the environmental groups that had stirred up trouble on Sakhalin for making "a deal with the devil" because the attention they had drawn had resulted in Gazprom taking majority control of the project. D,Souza believes Gazprom will produce a much poorer environmental record than Shell has thus far. He noted, however, that the environmental groups had played a useful role by keeping Shell honest.

MOSCOW 00002393 004 OF 007

Rosneft

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¶15. (C) Rosneft's Vice President for Finance, Peter O'Brien, boasted that Rosneft has enjoyed five years of oil production growth at more than 8 percent, although he did not specify in how many of those years growth was through acquisition (Yuganskneftegaz, Anglo-Siberian, Severnaya Neft) rather than organic growth. Rosneft is hiring experts from throughout the sector to remain the industry leader in growth, overtake Lukoil in production, and become competitive internationally with a market capitalization capable of supporting further acquisitions. Looking forward, Rosneft will continue to grow thanks in large part to its strategy in Eastern Siberia and the Far East (Sakhalin and Kamchatka). Rosneft is partnering with nearly every international major in one project or another, and with most Asian oil and gas companies as well. Rosneft characterizes its partnership with ExxonMobil in Sakhalin-1 as highly successful. The company hopes to get into the retail sector of several Asian countries ultimately and has also begun thinking about upstream activity in Vietnam.

¶16. (C) While eastern production accounts for only 5 percent of Rosneft's output now, by 2015 it will grow to 20 percent even accounting for a higher production level company-wide. With Rosneft's Vankor field, the company plans to be the major user of the East Siberian-Pacific Ocean (ESPO) pipeline, shipping 500,000 b/d or more by 2020. Rosneft and Transneft will have a "tariff discussion" to come to

agreement on a fee structure that works for both parties. That discussion will focus on Transneft's cost of capital prior to taking out loans or on Transneft simply acquiescing to the need to pay off its loans more slowly, because to date the pipeline seems too expensive. O'Brien said that even the Prime Minister has taken an interest in why ESPO is so expensive. Other East Siberian exploration will be spurred by the combination of ESPO and the recently enacted tax differentiation for east Siberian fields.

¶17. (C) O'Brien characterized the tax relief (for the first 25 million tons of a new East Siberian field) as a huge development incentive, equating to over a billion dollars for each field at current prices. Rosneft sends 180,000 b/d of crude to China by rail currently and notes that China's desire to get into Russia's upstream is an important lever to ensure that higher exports will secure world-level prices in the future. The "price at the end of the pipe" is a major concern so such leverage should help.

¶18. (C) Separately, USG officers visited Rosneft's Science and Technology Center in Moscow. Here Rosneft monitors and directs production, water-flooding programs, and other factors and calculates the most commercially favorable production profile for its fields. While the tour is largely a packaged presentation that Rosneft's public relations firm has prepared for dignitaries, it nonetheless demonstrated a competent, technically serious, and very young company that wants to advertise its sudden emergence into the ranks of the supermajors. In side conversations, Rosneft admits that at least 70 percent of its personnel came with the acquisition of Yuganskneftegaz's center and that most of the technology and reservoir management techniques were developed by Yukos' team of western reservoir engineers who delivered the production miracle to Yukos earlier this decade.

Vladimir Milov  
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¶19. (C) Vladimir Milov, president of the Institute for Energy Policy and former Deputy Energy Minister, offered his opinion on a wide range of topics, including the growing Chinese/Russian rivalry in Central Asia and energy relations between the two countries. He said that the Chinese have always wanted to buy an equity stake in a big Russian company and thought they had extracted a promise from the Russians to allow them to buy into Yuganskneftegaz when it was taken from Yukos. Rosneft ended up with this asset and the Chinese have

MOSCOW 00002393 005 OF 007

not forgotten this "broken promise."

¶20. (C) On Central Asia, Russia is clearly worried about Turkmenistan sending gas to China because Gazprom needs to lock up these volumes for itself. The current agreement between Russia and Turkmenistan is only good through 2009. Moscow has spent the last 15 years squeezing resources out of its Central Asian partners. As a result, Moscow's competitive advantage over Beijing in the region is being threatened. Because of its need for gas, Gazprom will undoubtedly muscle into TNK-BP's giant Kovykta gas project in East Siberia. The volumes can go to meet some of the gas volumes Putin committed to China during a trip to Beijing last year. The Sakhalin-1 project looks to be safe from Gazprom's predatory tendencies for the time being, he thought. It is likely that ExxonMobil (the operator of the project) and Gazprom will work out a way to export the gas.

International Energy Agency (IEA)  
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¶21. (C) Yo Osumi, head of Asia-Pacific, Latin America, and Sub-Saharan Africa at the IEA, gave a detailed presentation on Asian energy demand going forward. While China, India and other Asian giants are clearly going to continue leading the



globe in energy demand growth, there are more alternatives at their disposal than some realize. China's growth has been and can continue to be fueled by coal overall, but China will clearly welcome Russian oil. Muted Chinese demand for gas to date has left the country so far ambivalent about piped gas vs. LNG. Japan's interest in ESPO must stem definitively from a policy desire for diversification since Japanese oil demand is set to decline in coming decades. South Korea and, to a lesser extent, Japan could face strong needs to seek out Russian LNG (or in the case of South Korea, piped gas) in the future as gas demand grows and LNG contracts come up for renewal in the face of some Asian supply problems (primarily in Indonesia).

¶22. (C) India has had good luck with domestic gas discoveries recently but will continue to be a magnet for LNG and pipeline gas imports looking forward, although much depends on domestic energy price reform. IEA's recent criticism of Russia for not investing enough in gas development in the face of a growing call on Russian gas hit Chinese policymakers "square in the eye" and forced them to examine Russian gas from a new perspective. Meanwhile, the Chinese have always had a major footprint in Central Asia and IEA believes Chinese imports of major volumes of Central Asian gas is a likely scenario.

¶23. (C) In closing, Osumi stressed that diversification is everyone's energy policy goal, but that the key to success in this part of the world will be negotiations over pricing, the fate of coal use in China, and developments in the "LNG vs. piped gas" arena. "Avoidance of captivity," whether for a consumer or producer, will also be determined by internal and external politics and, sadly, the seemingly permanent corruption in the region.

Carnegie Center  
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¶24. (C) The Carnegie Moscow Center pulled together an array of experts to discuss emerging Russian-Asian energy linkages. Their emphasis was on the nature of the decision to construct the ESPO pipeline, different perceptions of China's role in the energy equation, and the importance of Central Asian gas.

-- Konstantin Simonov, General Director of the National Energy Security Fund, emphasized that the ESPO pipeline is a political, not a commercial, project. Whether it terminates in China or on the Pacific coast will be a reflection of friends Russia chooses at the time. Russian society is "very flexible" about China and not as fearful of it as many think. With so few resources identified to fill ESPO in the east, the pipeline really should be called WESPO since it will

MOSCOW 00002393 006 OF 007

require oil from West Siberia. This is a policy of "diversion, not diversification," he said.

-- Tatiana Mitrova of the Center for International Energy Markets Studies at the Russian Academy of Sciences argued that China and Russia do not understand each other yet on energy trade. Russia sees the flows through ESPO, and possibly the promised gas volumes, to China as a maximum but China views them as a "starting point." This conflict will grow and will exacerbate pricing negotiations. Agreements to date are nothing but declarations, whereas actual business deal-making will be exceptionally difficult. Timing is another huge issue as China and other markets opt for alternative sources of fuel. Russia's obsession with adding value to the economy by exporting products rather than raw materials is another stumbling block since Russia's would-be fuel customers do not want Russia to add value before the products cross the border. The G8 approach to energy security, focusing as it did on diversification for both consumers and producers, makes Russia's turn to the east a fundamentally strategic rather than commercial issue.

-- Vasiliy Mikheev of the Institute of World Economy and International Relations argued that Russia's recent statements about its strategic foreign policy direction have been misconstrued by the West. The West has mistakenly focused on Putin's message in Munich, for example, interpreting it to mean that Putin was only criticizing those who would limit Russia's competitiveness. In fact Putin raised ten points of cooperation with the West as well. It is through this sort of prism that Russia views who is helping and who is hurting Russia, and energy security is part of that prism. On the issue of Russia-China relations, Mikheev argued that China is both a cooperator and a competitor with Russia. It would be a psychic shock for Russia to see China on Russian soil developing oil or gas, as Russia is not prepared to accept China as an equal the way it does the U.S., the EU, or Japan. China on the other hand is not satisfied with the level of mutual trust with Russia. Central Asia, meanwhile, will play Russian and Chinese competition off one another.

-- Vladimir Milov pointed out that much of the hype about eastern Russian hydrocarbon riches is overblown. Proved reserves are tiny compared with western Russia, high taxes on production that work in western Russia where sunk costs make such a government take possible will not work in the east, and the only projects in the east showing "signs of life" are the two PSA projects run by westerners. Milov argued for focusing less on energy as an economic linchpin for eastern Russian development in favor of more focus on overall transportation links with the Asia-Pacific world. While some fear this might split Russia in two, Milov believes it would instead ground eastern development in economic and geographic reality as opposed to the centrally-planned energy projects that are little more than a political way to glue the country together. Regarding Central Asia, Milov believes that all the states want transit independence and customer diversity after years of "broken promises" from Russia on transit and a blatantly self-interested Russian position on the Energy Charter Treaty. Russia is taking a short-sighted view of Central Asia but still has a firm grip on those states. Russia will have to change its strategy in the face of Chinese inroads to Central Asia, however.

125. (C) Asked in closing what advice they would give the USG on taking a policy position towards emerging Russia-Asia energy trade and geopolitics, participants offered the following advice:

-- China is really the key, not Russia. The U.S. must decide what China represents in energy matters --friend or foe? Then, the U.S. should develop a strategy of cooperation with China and only then incorporate Russia into the equations.

-- Take a firm position, reflected recently by the NSC to some audiences, that demonstrates that the USG is strategically interested in Russia having a presence in the Pacific Rim. U.S. advice to all on how to achieve that

MOSCOW 00002393 007 OF 007

integration will be much appreciated.

-- Be gentle in handling developments in the energy geopolitics of the region and avoid over-reacting. Do not regard ESPO as merely a commercial or a political exercise -- it is both. Russia will continue maneuvering on ESPO until it finds enough reserves to fill it and will continue to play China, Japan, South Korea and the U.S. off against one another as it seeks the most comfortable partnership at the moment. Recognize that Central Asian gas is being pulled in four directions and that there is not enough to fill all or even most of them. The USG should take a position on Central Asian gas to China.

126. (U) This cable was cleared by all conference participants.  
BURNS